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**ECONOMIC LIBERALIZATION IN LESS DEVELOPING COUNTRIES:  
THE CHILEAN CASE**

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## **Abstract**

The liberalization and reregulation of the Chilean economy from 1973 through 1983 generates useful lessons on potential pitfalls in the transition from an illiberal to a liberalized economy. This article reviews the measures adopted by Chilean authorities during this period and their macro impact on the economy. Particular attention is devoted to the role of the financial sector in the economic crisis that emerged in the early 1980s. This experience underscores the need for appropriate regulation in an economy ongoing deregulation.

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# **ECONOMIC LIBERALIZATION IN LESS DEVELOPING COUNTRIES: THE CHILEAN CASE**

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## **INTRODUCTION**

In the last several years a considerable body of evidence has accumulated about the process of economic liberalization in less developing countries (LDCs). During the 1970s many Latin American countries - most noticeably, the southern cone countries - adopted a new set of policies to deal with their long-standing economic problems. The specifics of the strategies differed among countries, however, all strategies implied one or more of the following measures: (a) an opening of foreign trade; (b) deregulation of the domestic financial market - i.e., elimination of domestic credit controls, interest-rate ceilings, and differential reserve requirements; (c) an opening to international financial flows; and (d), the elimination of entry barriers for foreign banks. The specific objective of these liberalization policies was to eliminate distortions in the allocation of resources and change the country's basic economic structure. However, international economic events have demonstrated the vulnerability of individual countries to external disturbances or "shocks". Thus, the positive effects of such policies turned out to be short-lived and the countries that had been at the forefront of liberalization suffered significant reversals in their economic performance.

Increases in the price of crude oil in 1974 and 1979-1980, stagnation of world demand for primary products in 1980-1982, and the concurrent worsening of the terms of trade were the major

disturbances during the 1970s and 1980s. Substantial increases in real interest rates were another shock that increased balance-of-payment pressures on debtor countries. All these shocks forced major adjustments in the trade flows of the domestic economies of developing countries'. Another "shock" to the domestic economy was inconsistent and counterproductive government policies attempting to restore efficient resource use following changes in the external environment.

Shock induced structural adjustment occurs in both production and expenditure decisions when economic decision-making is governed by rational (optimizing) behavior. Adjustment to external shocks and government policies has both sector specific ("microeconomic") and economy-wide ("macroeconomic") dimensions. The microeconomic perspective underscores the effect of the adjustment process on the structure, conduct, and performance of a specific sector. Macroeconomic analysis highlights the impact of the adjustment process on economic growth, inflation, and the trade balance.

Oil importing developing countries, (OIDCs) in contrast to developed countries, failed to adopt appropriate measures to adjust their economies to changes in the economic environment during the 1970s. Despite this contrasting performance the oil import dependence of both developed and oil importing developing economies is comparable. Yet, as shown in Table 1, the ratio of the current account deficit to GNP rose much more rapidly for the OIDCs than for the developed countries. The deficits of the larger OIDCs resulted in a significant jump in their net debt (defined as gross debt minus foreign exchange reserves) as a percent of gross national product. Again in 1979 and 1980 increasing current account deficits resulted in increasing debts for OIDCs.

The Chilean economy provides an interesting case study of the process of economic liberalization in OIDs during the 1970s and 1980s. For 14 years, between 1973 and 1987, a deep process of economic liberalization has been implemented which transformed the Chilean economy. Reform of the financial system, the opening of the foreign trade sector and domestic stabilization policies were the three key "initiatives" in this open market model. As can be seen in Table 2, this process of economic liberalization was bracketed by two recessions in 1975 and 1982, years in which the Gross Domestic Product (GDP) fell 12.9 percent and 14.3 percent, respectively. The 1982 recession was accompanied by a collapse of the financial system that brought about, in January 1983, massive government intervention in the commercial banking system.

Several explanations have been advanced to explain the disappointing results described above. In general, the explanations have pointed to government mismanagement in the implementation of liberalization and stabilization measures, and to the role of external shocks as the principal causes of these negative results. A point on which all agree is the contribution of a poorly regulated financial system.

The aim of this paper is to evaluate the stabilization and liberalization measures that Chilean economic authorities implemented after September 1973. More specifically we document and evaluate the financial crisis of 1982 and its aftermath.

The paper is organized in five sections: Section I presents some of the more important measures contained in the economic reform package implemented by the Chilean military regime after September 1973; section II evaluates the principal effects of these reforms on the Chilean economy; Section III analyzes the impact, by region and economic activity, of the economic

reform and external shocks on deposit and loan activities of the Chilean financial system during the 1970s and early 1980s; section IV presents details related to the financial crisis growing out of the recession of 1982. Section V presents the concluding remarks.

## **I THE KEY POLICY MEASURES OF ECONOMIC STABILIZATION AND LIBERALIZATION**

In 1973 the Chilean economy was in severe macroeconomic disequilibrium, suffering acute foreign exchange shortages, and high inflation. Extensive price controls, protective tariffs, quotas, subsidies and export taxes maintained a severely distorted structure of relative prices. Late in 1973, the Chilean political environment changed drastically when a military regime assumed political power. The new government implemented an economic reform package to control relative price distortions and reduce inflation. The most important reforms were in domestic commodity markets and the foreign trade sector. However, important reforms were also implemented in the capital and financial markets, and finally in the labor market.

### **Domestic Price Liberalization**

The deregulation of domestic prices was a top priority. Price deregulation began in October 1973 with the enactment of decree law 522 which defined pricing criteria for a wide range of goods and services. The prices of a large group of goods were allowed to be freely determined by producers and importers. The prices of a second group of commodities, such as sugar, oil, tea, milk, and processed foods were allowed to be modified subject to previous cost studies. Finally, prices for a third group of goods and services could be modified by merely informing the



economic authorities of the new prices . The final step in domestic price deregulation was taken in December 1980, when a new decree law (No. 3529) prohibited the transfer of commodities in group three above to the category containing goods with fixed prices.

### **Foreign Trade Policies**

In October 1973 a process of tariff liberalization and a new exchange rate regime were initiated. On the one hand, the average tariff was reduced from 106 percent to a uniform rate of 10 percent tariff rate in 1977. On the other hand, the new exchange rate regime reduced a multiple exchange rate regime to a three-rate system. This change was accompanied by a 300 percent devaluation of the peso. During 1974, 24 devaluations were made with a mean devaluation rate of 6.9 percent, and an annual rate of 392.1 percent (Corbo, 1986). In 1975 the exchange rate policy introduced mini devaluations. During 1976 a 10 percent revaluation was effected and a new devaluation mechanism was introduced indexing the exchange rate to the rate of inflation. In December 1977 the government announced that the rate of devaluation would exceed the inflation rate to compensate for tariff reductions. In February 1978 another exchange rate regime was implemented. This new regime consisted of pre-announced mini devaluations, known as "la tablita". In June 1979 the exchange rate was fixed at a rate of 39 pesos per dollar. This rate was maintained until June 1982, when a devaluation of 18 percent was carried out, and the peso was pegged to a basket of foreign currencies.

### **Capital and Financial Market Reforms**

The reforms in the financial market were numerous. In December 1973 new bank establishments were prohibited until December 1974 when rules were enacted with respect to the organization and functioning of financial institutions. In January 1976 a law was enacted covering the management of mutual funds (*fondos mutuos*).

Until September 1973, nominal interest rates were fixed by the Central Bank. Since real interest rates were highly negative, most credit was allocated by quotas. The liberalization of domestic financial markets began in May 1974 when financial corporations (*financieras*) were authorized to determine freely the interest rate for deposits with a maturity longer than 60 days. In May 1974 the interest rates on loans were also liberalized subject to the constraint that they did not exceed 50 percent of the current interest rate for inflation-adjusted operations or non-adjusted operations, whichever was relevant for the case in question. By June 1975 this limit was completely eliminated. In October 1975, commercial banks were finally authorized to determine freely their deposit and loan rates. As the regulatory advantages for *financieras* were reduced these institutions lost importance in financial markets. With respect to debt allowances, the maximum debt/capital ratio for commercial banks had been 20 since 1974. The capital account remained virtually closed until September 1977 when commercial banks were allowed finally to engage in foreign debt transactions under article 14 of the exchange rate regime.<sup>1</sup> However, the maximum monthly inflow was limited to 5 percent of the capital and reserves of each bank. Before 1977, only public sector and large private enterprises intermediated most medium-term capital inflows. Banks were only involved in the short-term finance.

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<sup>1</sup> Article 14 refers to the permission given by the Central Bank to borrowers for future access to foreign exchange to service a foreign debt.

In June 1979, commercial banks were allowed to intermediate capital inflows with an overall (internal and external) borrowing limit established at twenty times their capital and reserves. At the same time, the amount of monthly borrowing under article 14 was reduced to 5 percent of capital and reserves or one million dollars, whichever was lower. This restriction, however, was completely eliminated in April 1980 .

### **Labor Market Reforms**

Reforms in the labor sector began in 1974 when discriminatory benefits were gradually eliminated. Family allowances and retirement ages were made uniform for blue-collar and white-collar workers. Social security contributions were slowly reduced, and labor union power was severely constrained. In 1979 and 1981 vacations, indemnizations, and employee profit sharing were made more flexible for owners. Furthermore, employers were authorized to lay-off workers without justification, and the minimum salary was reduced. In 1979 the labor plan reintroduced collective bargaining and wages were indexed to the consumer price index (CPI). However in June 1982, after the first devaluation in three years, wage indexation was suspended, and in December of that year corrective legislation was introduced for a wage floor.

## II THE MACRO-RESULTS OF THE ECONOMIC REFORMS

### Macroeconomic Effects

By 1975 some of the government's objectives were partially achieved (see Table 2). The fiscal deficit was reduced from 24.7 percent in 1973 to only 2.6 percent of Gross Domestic Product (GDP) in 1975. The balance-of-payments crisis was averted, and relative prices were realigned. Although the reduction of inflation was a top priority, a gradual stabilization policy was adopted to avoid excessive "social cost" of a shock treatment. In 1975 M1 increased 258 percent, slightly slower than the most expansionary year of the Allende regime (i.e., 317 percent in 1973). On the other hand, the world recession of 1974-75 affected Chile severely. By 1975 the Chilean economy was experiencing a deep fall in GDP (12.9 percent), despite the gradual stabilization program.

The rigor of the fiscal measures were felt immediately. By December 1974 output in the manufacturing sector fell 12.8 percent compared to December 1973, and by December 1975 manufacturing output had fallen 21 percent with respect to December 1974 (Table 2 Column 7). The unemployment rate also experienced marked increases. In 1975 the unemployment rate in Greater Santiago had increased dramatically to 16.2 percent from 4.7 percent in 1973 (Table 2 Column 8). However this increase in unemployment is somewhat exaggerated. The low rate of unemployment recorded for 1973 reflects an artificially high employment rate generated by politically inspired measures in the last year of the Allende Administration to force a high level of featherbedded employment in many enterprises falling into state receivership. This level of employment could never have been economically sustained in the future.

The stabilization program had a limited effect in reducing inflation. By the end of 1975 the annual rate of inflation stood at 340 percent (Table 2 Column 2). By 1975 the deterioration in the terms of trade had reached alarming levels, 37 percent with respect to 1974 (Column 9), at the same time the projected deficit of the balance of payment reached 344 million dollars (Column 3).

After these disappointing results the government decided to apply drastic anti-inflationary measures with a tighter monetary policy. These actions reduced the annual rate of growth of M1 from 258 percent at the end of December 1975 to 67 percent at the end of 1978 (Table 2 Column 4) with consequent decline in inflation from 174.3 percent in 1976, to 63.5 percent in 1977, and only 30.3 percent in 1978. The economy rapidly recovered showing a record increase of GDP of 9.9 percent in 1977. Industrial production increased to a record level in 1976. Nevertheless, despite the positive results generated by this severe anti-inflationary policy, the government still considered inflation excessive.

A new stabilization program was launched in February 1978, with the exchange rate as the principal instrument to reduce the inflationary impact of frequent devaluations. The objective was to reduce the inflationary expectations of the private sector. Nevertheless, inflation did not decline. On the contrary, prices increased almost 40 percent in 1979. This led the government to adopt the extreme measure of a fixed exchange rate in June 1979.

Contrary to government expectations, as shown in Table 3, inflation did not decline to the world (i.e., U.S.) level. The exchange rate freeze in 1979 and the lack of convergence of Chilean inflation to world inflation brought a growing overvaluation of the exchange rate. As seen in Table 2, the terms of trade began to deteriorate by 9 percent in 1980 and 24 and 18 percent in 1981 and 1982. This period concluded with a deep recession in 1982 in which GDP fell 14.3 percent. The

unemployment rate reached levels never seen before in Greater Santiago, 22.1 percent. The balance of payments deficit reached record levels of 1,165 and 541 million dollars in 1982 and 1983, respectively.

### **The Financial Crisis**

The 1982 recession was accompanied by a severe crisis in the financial sector. This triggered massive government intervention in the commercial banking system on January 13 1983, and brought an end to the laissez-faire approach that had characterized Chilean financial policies in the post-1973 era. The principal feature of this laissez-faire world permitted commercial banks to merge and consolidate into an oligopolistic market structure. Furthermore, they were allowed to combine with non-bank enterprises to form economic groups or conglomerates. This ignored the potential conflicts of interest that could, and in fact did, emerge as alleged banks drew upon depositor funds to try and bail out failing conglomerate firms during the recession. This lack of explicit regulatory protection of depositor interests increased the element of "moral hazard" in the Chilean financial system (McKinnon 1988).

Between 1983 and 1986 the government engaged in two global reschedulings of private sector debt (foreign and domestic), purchased large quantities of uncollectible loans from the banks at face value, provided large subsidies to dollar debtors, and monitored the bankruptcy and restructuring of some of the largest firms in the economy. Only by mid-1986 did the financial system begin to return to normal with the re-privatization of a number of large banks and financial companies.

### III EVOLUTION AND CHANGE IN THE FINANCIAL SECTOR

The metropolitan area of Santiago, the Aconcagua - Valparaiso (region V), and the Ñuble - Concepcion (region VII) are traditionally the regions in which more than 70 percent of deposit and loan activities of the Chilean financial system have been concentrated. Therefore an analysis of the financial activity in these regions is important to understand the Chilean financial crisis in 1982. In this section we shall analyze the financial statistics of these three regions with special emphasis on loan allocation by region and economic activity.

#### **Deposits by Region**

As can be seen in Table 4, until 1983 deposits in Chilean currency were highly concentrated in the Metropolitan region. Chilean deposits in this region increased from 56.9 percent in 1970 to 69.7 percent in 1983. In the meantime, the share of deposits in Chilean currency fell from 11.0 and 8.3 percent in 1970 to 9.0 and 5.6 percent in 1983 in regions V and VII, respectively.

The regional concentration of deposits in foreign currency in 1979 and 1980 was even higher than the regional concentration of deposits in Chilean currency. Thus, more than 76.9 percent of the deposits in foreign currency in 1979-1980 period were held in the Metropolitan area. Another 13.7 percent was held in region V. Thus, more than 90 percent of the deposits in foreign currency were concentrated in the Metropolitan area of Santiago and the Aconcagua-Valparaiso region (i.e. region V). This extremely high concentration of deposit activity in the Metropolitan region is a reflection of a high degree of unbalanced regional development.

### **Loans by Region**

As early as 1970 Table 4 shows that the Santiago Metropolitan Area received 68.3 percent of the total loans in Chilean currency. The lowest value of the decade was reached in 1974 (61.7 percent). This share, however, climbed steadily from 64.9 percent in 1975 to 77.6 percent in 1980.

Region VII (Ñuble - Concepcion) appeared to be highly affected during the period of economic liberalization. In fact this region's share of loans in Chilean currency suffered a substantial decline from 5.0 percent in 1970 to 2.4 percent in 1980. Region V (Aconcagua - Valparaiso) experienced a slight fall from 6.7 percent in 1970 to 6.2 percent in 1980. Thus, loan concentration, similar to deposit concentration, increased markedly during the period of financial and trade liberalization. This suggests the existence of imperfections in the financial sector preventing a more balanced distribution of credit.

### **Loans by Economic Activity**

Table 5 indicates that during the Allende administration, loans in Chilean currency to the public sector increased five-fold in a two year period, from 5.3 percent in 1970 to 26.7 percent in 1972. The tradable sector suffered the sharpest decline in terms of relative importance, with its share falling from 61.6 percent in 1970 to 31.3 percent in 1972 (Table 5). Subsequently, during the period 1973-1978 bank loans to the tradable sector increased to 50.2 percent and credit to the public sector decreased from 52.6 percent in 1973 to only 5 percent of total credit in 1978.

The period 1979-1983 shows a declining trend in loans to the tradable sector in Table 5, while the share of loans to intermediate non-tradable activities increased steadily from 24.9 percent



of total credit in 1978 to 50.1 percent in 1983. There was an important increase in private sector credit classified as others (i.e. not-well specified activities). In fact, these loans increased four-fold in a three-year period from 1978 to 1981. The opening of the capital account in 1979 appears to be related to this surprising increase in the financing of these poorly specified activities.

The credit in dollar loans shows similar characteristics to the allocation of credit in local currency. However, there is a sharp decrease in dollar loans to the public sector. In 1974, dollar loans to the public sector registered more than 10 percent, however, by the end of 1984 there was practically no dollar credit to the public sector. Dollar Credit for non-tradable intermediate activities were highly favored. Immediately after 1979, with the opening of the capital account, the share of dollar credit allocated to tradable activities began to decline and the credit to non-tradable activities, both intermediate and final goods increased. This situation appears to be linked to the growing overvaluation of the exchange rate during 1979-1982.

As seen in Table 6, the share of agriculture, forestry, and fisheries in total bank loans in Chilean currency, which had fallen from 24.3 percent in 1970 to 19.8 percent in 1972, has fluctuated sharply since 1973. This share increased to 36 percent of total loans in 1976. However, it decreased to 21.5 percent by 1978. The share of credit to manufacturing industries followed a similar pattern increasing from 13.3 percent of total credit in 1973 to 37.5 percent in 1975.<sup>2</sup> However, the share in total credit of this sector declined to 27.2 percent in 1977 with a slight recovery in 1978 (27.9 percent).

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<sup>2</sup> This sharp change was in part due to the reduction of credit to the area of social ownership.

The share of the trade sector in total credit showed the most significant change during this period. The share of total bank credit in domestic currency allocated to trade increased from 4.6 percent in 1973 to 22.4 percent in 1978. Another important change in the structure of bank loans is the share of bank loans in Chilean currency to communal, social and personal services, which increased from a modest 2.3 percent of total credit to 8.9 percent in 1978. Particularly evident is the unusual increase of consumer credit from 1.5 percent in 1977 to 5 percent of total credit in 1978. The share of loans going to the financial sector rose from 4.7 percent in June 1979 to 24.2 percent in December 1982, an increase that can be explained by the decline of this sector as a result of trade liberalization, the introduction of a fixed exchange rate, and by the increasing dependency of conglomerate enterprises on foreign currency loans. The share of the trade sector in total credit declined from 22.8 percent in June 1979 to 14.5 percent in December 1983. During this same period the share of the primary sector (agriculture, forestry, and fisheries) declined sharply from 18.7 percent, in June 1979 to 12.8 percent in December 1983. Finally, the proportion of loans in domestic currency to the construction sector increased from 4.8 percent in June 1979 to 11.3 percent in December 1983. Dollar loans directed towards non-tradeable intermediate activities increased sharply from 16 percent of total loans in 1978 to 30.7 percent in 1982. Furthermore, the dollar credits to tradeable activities were drastically reduced from 64.4 percent of total loans in 1978 to 37.2 percent in 1982 (Table 7).

#### **IV ECONOMIC REFORM AND FINANCIAL COLLAPSE: THE ISSUES AND THE EVIDENCE**

Several explanations have been emphasized to explain the financial collapse in Chile. Government mismanagement in the implementation of its liberalization and stabilization measures, and external shocks have been pointed out as the major causes of the disappointing results described earlier.

The discussion surrounding the government's mismanagement has centered on four decisions taken after 1978:

1. The fixing of the exchange rate in June 1979;
2. The decision to legislate the complete indexation of nominal wages to past inflation in June 1979;
3. The substantial relaxation of controls on the capital account of the balance of payments during 1979 and 1980; and,
4. The existence of a poorly regulated financial system deficient in protecting depositors interests.

Corbo (1985) has attributed the main responsibility of the 1982 deep recession and financial crisis to the fixed exchange rate regime established in 1979. This led to an increasing overvaluation of the Chilean peso during the period 1979-1982. Harberger (1984), however, has suggested that the effect of overvaluation only began to impact the Chilean economy in 1981, almost two years after the fixing of the exchange rate. In fact, as Table 8 (column 3) shows, only in 1981 did the relative price of tradeables (i.e. the, rate of growth of the ratio WPI/CPI) decrease by 8.0

percent with respect to 1980.<sup>3</sup> Industrial production was also affected only in 1981, the year in which the manufacturing industrial production index declined 18 percent. An additional fall of 13.1 percent was experienced by this index in 1982.

Corbo (1985), and Edwards (1985) among others, have argued that another important mistake was wage indexation from 1979 onwards. The real wage was "out of line" from the very beginning of the fixed exchange rate regime. This argument has been challenged by Harberger (1984) who establishes the fact that the difference between the growth of real wages and GDP was only 0.9 percent in 1980. Furthermore, this difference only increased in the second semester of 1981, so that the indexation of wages became a binding constraint only in the second half of 1981, when the rate of growth of GDP began to slowdown. It has been argued that wage indexation only became a serious problem when the wage salary index fell 0.2 percent while GDP fell by 14.3 percent in 1982, thus creating a sharp disequilibrium.

The sharp reduction in net capital inflows created pressures for devaluation in 1982. Table 9 shows that the rate of net capital inflows sharply decreased from 14.4 percent of GDP in 1981 to 5.4 percent of GDP in 1982. Thus, as Harberger claims, an exchange rate that appeared to be reasonably viable in the presence of large capital inflows was no longer viable when external financial flows virtually dried up.

The liberalization of the capital markets faced three main problems:

1. The high level of real interest rates on loans;

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<sup>3</sup> The relative price of tradeables was proxied by the ratio between the wholesale price index (WPI), which is strongly influenced by traded products, and the consumer price index (CPI), which contains tradeable and non-tradeable products.

2. The low level of domestic savings; and,
3. Weak government regulations and supervision over lending activity by the financial system (i.e., no deposit insurance, no controls for conflict of interest loans, and lax loan exposure regulations).

As can be seen from Table 10 even after the capital account opened and the exchange rate was pegged against the dollar in 1979, there was still a substantial differential between domestic and foreign (LIBOR) real interest rates.

This situation, along with the wide spreads between deposit and lending rates, as can be seen in Table 11, reflect inefficiency in financial intermediation and market imperfections (i.e. lack of competition) in the Chilean banking system. Arellano (1984) argued that the Chilean banking system had much higher operational costs than banks of comparable size in the United States and other industrialized countries.

Edwards and Edwards (1987) explain the low level of domestic saving, among other factors, by increased foreign indebtedness. This increased the volume of loan activity without increasing domestic saving. The lowest level of gross domestic saving was reached in 1981, at the same time that the growth of foreign indebtedness achieved its highest level (see Table 12).

One result of the financial reforms was that both the number of financial institutions and the volume of intermediation greatly increased. In fact, in 1981 there were 26 national banks, 15 financial corporations, and 19 foreign banks, a number sharply higher than the 18 national banks and one "financiera" in 1973. However, these increased numbers did not necessarily imply healthy competition. The lack of conflict-of-interest regulations and lax loan-exposure rules meant that the

increased portfolio concentration of conglomerate groups increased risk exposure (i.e., moral hazard) of the Chilean banking system.

Selected indicators of financial sector behavior are shown in table 13. The proportion of total credit going to the private sector increased from 47.4 percent in 1973 to 98.9 percent in 1981. In addition, the volume of financial intermediation increased. As can be seen in Table 4, M2, measured as a proportion of GDP, increased from 10.7 percent in 1973 to 21.2 percent in 1981.

Unfortunately, this growth in financial intermediation was not accompanied with effective supervision and regulation of the domestic capital market. The weaknesses of supervision and control were manifested in 1974 when a number of informal financial corporations started to operate. Furthermore, a handful of powerful conglomerates (grupos) began to control the country's major banks. These group-owned banks concentrated a large share of their loan portfolios in "related firms" which were either owned or controlled by the particular group in question. Table 14 shows that in mid-1983 a fifth (21 percent) of the total credit of private banks was allocated to firms controlled by bank shareholders; a major increase from the mid-1982 ratio (16.4 percent). These groups concentrated their activities in the export sector, the sector that was most favored in term of credit allocation during 1978-1981. This sector was also the most affected by the world recession of 1982. These groups generated large capital gains by investing in the securities of related non-bank enterprises. Such activities allowed them to support relatively poor operational returns, and their ownership of major banks allowed them to consolidate control of a large volume of assets through debt finance (for details see Galvez and Tybout, 1985). Finally, Diaz- Alejandro (1986), Edwards (1985), Corbo (1985), and Arellano (1984) have argued that the

rescue of all depositors and creditors in 1977 for one of the national banks (the Banco Osorno) provided a de facto deposit insurance precedent for these conglomerate banks to ignore risk in their future lending activities, generating serious moral hazard problems.

## **V CONCLUDING REMARKS**

Government mismanagement and a poorly regulated financial system cannot explain by themselves all the variations in Chilean economic growth during the 1970s and 1980s. Aggregate supply disturbances have also played an important role in explaining the recessions of 1974-1975 and 1982 in Chile. In fact, Chile is a country highly dependent on imported materials. Imported intermediate goods make up a large share of total inputs in the country. Chilean intermediate good dependence may be observed in Table 15 where more than 50 percent of total imports during the period 1973-1981 corresponds to imported materials. Chilean intermediate good imports increased from 58.3 percent in 1972 to 66.0 percent and 72.8, in 1973 and 1974, respectively, in response to the first oil-shock in 1973.

After 1976, however, these imports began to decline to reach the lowest level of intermediate good imports in 1981 with 50.4 percent of total imports. During those years, in which the Chilean economy was at its highest growth level of the decade, consumption good imports constituted more than 20 percent of total imports. This reached the highest level in 1981 (i.e., 29.9 percent of total imports). On the other hand, capital good imports showed relatively stable levels, falling below 20 percent of imports only after 1981. It is interesting to note that foreign debt increased mainly to support increased consumption good imports.

In summary the rapid pace of economic liberalization in Chile from the mid 1970s through the early 1980s emphasized growing international indebtedness and growing consumption through foreign debt financed imports. Economic policies from 1982 to the present clearly had to redress both these structural deficiencies of recent Chilean growth.



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## TABLES

TABLE 1: CURRENT ACCOUNT AND NET DEBT AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT. MAJOR REGIONS 1972-79								
ITEM	1972	1973	1974	1975	1976	1977	1978	1979
Current Account/GDP	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Developed Countries (a)	0.4	0.4	-0.9	0.2	-0.4	-0.5	0.3	-0.5
OIDCs (b)	-1.5	-1.4	-3.9	-4.9	-3.2	-2.2	-2.4	-2.7
Net Debt/GDP (c)								
OIDCs	13.7	12.3	12.9	16.3	16.9	18.0	18.5	17.7
Source: J. Sachs (1981)								
(a) Developed countries refers to all industrial countries.								
(b) Oil importing developing countries.								
(c) Net debt is defined as gross debt minus foreign exchange reserves.								

Current Account      Exports FOB + (Imports FOB) + other goods & semi-income net  
+ unequited transfers.

TABLE 2: SELECTED INDICATORS OF THE CHILEAN ECONOMY 1970-1985

YEARS	ANNUAL GROWTH OF GDP	INFLATION OF (DECEMBER-DECEMBER)	BALANCE OF PAYMENTS SURPLUS (MILLION US\$)	RATE OF GROWTH OF M1* (DECEMBER-DECEMBER)	FISCAL DEFICIT AS PERCENTAGE OF GDP	RATE OF DEVALUATION OF PESO (DECEMBER-DECEMBER)	RATE OF VARIATION MANUFACTURING PRODUCTION INDEX (DECEMBER-DECEMBER)	UNEMPLOYMENT GREATER SANTIAGO (ANNUAL AVERAGE)	TERMS OF TRADE (ANNUAL VARIATION)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1970	2.1%	34.9%	113.5%	---	2.7%	---	-5.5%	7.1%	-11.0%
1971	9.0	22.1	-299.5	110	10.7	19.5	31.3	5.5	-21.0
1972	-1.2	163.4	-230.8	157	13.0	71.2	-6.2	3.7	-7.0
1973	-5.6	508.8	-21.0	317	24.7	1271.0	-5.6	4.7	-38.0
1974	1.0	375.9	-55.0	272	10.5	372.0	-12.8	9.7	-7.0
1975	-12.9	340.7	-344.0	258	2.6	409.0	-21.2	16.2	-37.0
1976	3.5	174.3	414.0	199	2.3	106.0	13.4	16.8	2.0
1977	9.9	63.5	113.0	108	1.8	62.0	2.3	13.2	-10.0
1978	8.2	30.3	712.0	67	0.8	22.0	5.3	14.0	-2.0
1979	8.3	38.9	1047.0	65	-1.7	15.0	6.6	13.6	42.0
1980	7.8	31.2	1244.0	57	-3.1	0.0	13.3	11.8	-9.0
1981	5.7	9.5	67.0	-6	-1.7	0.0	-18.4	11.1	-24.0
1982	-14.3	20.7	-1165.0	9	2.3*	85.0	-13.1	22.1	-18.0
1983	-0.7	23.1	-541.0	27	3.8*	20.0	4.9	---	10.9
1984	6.3	23.0	17.0*	12	4.1*	45.0	9.9	---	-3.6
1985	2.4	26.4	-99.0*	11	---	44.0	---	---	-9.1

SOURCE: Columns 1-7 were obtained from Banco Central de Chile, Monthly Bulletin (various issues). Column 8 obtained from Department of Economics, University of Chile. Column 9 comes from Cortez (1984) and updated after 1983 with Banco Central de Chile, Bulletin.

(a) - M1 = Private sector money = Money in Circulation (C) + drawable money of private sector (D1)

Where C = Money in Circulation (Bank notes, coins and checks issued by Central Bank minus funds of financial system).

D1 = drawable money of private sector (deposits of non-financial private sector in banking current accounts net of legal reserve).

Table 3: DEVALUATION, CHILEAN INFLATION, AND U.S. INFLATION: 1979-1983.

Year	Annual Rate of devaluation of the peso	Annualized U.S. WPI rate of inflation	Annualized U.S. CPI rate of inflation	Annualized Chilean CPI rate of inflation
	(1)	(2)	(3)	(4)
1978	22.0	9.6	9.1	37.2
1979	15.0	14.9	13.3	38.0
1980	0.0	12.3	12.4	31.2
1981	0.0	5.6	8.9	9.5
1982	88.3	1.5	3.9	20.7
1983	19.2	1.8	3.8	23.1

Source: Edwards & Edwards (1987)

TABLE 4: AVERAGE ANNUAL DEPOSITS IN CHILEAN CURRENCY THE 30th OF EACH MONTH, 1970-1983, SELECTED REGIONS.

(PERCENTAGE OF TOTAL DEPOSITS)

Years	REGION		
	Metropolitan	V	VIII
1970	56.9	11.0	8.3
1971	58.5	10.8	8.2
1972	61.3	9.7	7.3
1973	62.6	9.1	6.9
1974	61.2	10.4	7.2
1975	61.2	10.4	7.2
1976	62.8	10.0	6.7
1977	64.8	9.6	6.2
1978	67.7	9.3	5.6
1979	69.1	9.5	5.5
1980	73.2	7.9	4.9
1981	74.7	7.9	4.5
1982	72.6	8.6	5.6
1983	69.7	9.0	5.6

Source: Mamalakis (1983)

TABLE 5: AVERAGE ANNUAL LOANS IN CHILEAN CURRENCY THE 30th OF EACH MONTH,  
1970-80, SELECTED REGIONS.

(PERCENTAGE OF TOTAL LOANS)

Years	REGION		
	Metropolitan	V	VII
1970	68.3	6.7	5.0
1971	67.7	6.4	4.3
1972	69.6	6.5	4.9
1973	67.0	8.1	5.3
1974	61.7	7.2	5.7
1975	64.9	4.2	5.7
1976	63.8	4.8	6.7
1977	68.8	5.2	5.7
1978	69.7	4.5	4.4
1979	75.4	5.8	2.9
1980	77.6	6.2	2.4
Source: Mamalakis (1983)			

TABLE 6: STRUCTURE OF CHILEAN FINANCIAL SYSTEM'S PESO LOANS  
(PERCENTAGE OF TOTAL LOANS)

PRIVATE SECTOR (a)						PUBLIC SECTOR
Years (b)	Tradable	Non - Tradable				
		Intermediate	Final	Others	Total	Total
1970	61.6	22.8	10.2	--	94.7	5.3
1971	60.0	20.2	10.0	--	90.2	9.7
1972	31.3	15.8	6.9	--	--	26.7
1973	32.9	10.3	2.3	2.0	47.4	52.6
1974	59.1	9.0	2.4	1.6	--	17.5
1975	74.5	10.2	5.6	2.7	9.3	7.4
1976	69.3	10.7	5.4	2.1	87.5	12.0
1977	52.5	23.5	6.0	5.5	87.5	11.8
1978	50.2	29.9	8.9	5.0	94.	5.0
1979	44.9	37.8	3.4	12.9	99.	4.4
1980	30.0	43.4	5.2	17.9	96.5	1.1
1981	24.3	46.6	5.1	22.9	98.9	0.6
1982	24.0	44.6	9.5	13.5	91.6	10.8(c)
1983	24.9	50.1	15.6	8.6	--	5.9(c)

Source: Superintendency of Banks and Financial Institutions

(a) Tradable Activities: Agriculture, Forestry, Fishing, Mining and Manufacturing.

Non Tradable Intermediate Activities: Electricity, Gas, Water, Construction, Transport and Communications, Wholesale and Retail Commerce, Financial Services.

Non Tradable Services Final Activities: Services, Personal Credit to consumers.

Others: Not-well-specified Activities.

(b) 1970-78 average annual Loans the 30th of each month.

1979-83 outstanding loans the 30th of June of each years.

(c) 1982 and 1983 are loans balances on the 30th of December.



TABLE 7: STRUCTURE OF CHILEAN FINANCIAL SYSTEM'S PESO LOANS BY ECONOMIC ACTIVITY 1970-1983

[illegible]

TABLE 8: STRUCTURE OF CHILEAN FINANCIAL SYSTEM: DOLLAR LOANS (PERCENTAGE OF TOTAL DOLLAR LOANS)				
PRIVATE SECTOR				PUBLIC SECTOR
Years	Tradable	Non - Tradable		
		Intermediate	Final	
1969	52.6	3.1	0.8	43.6
1974	24.0	1.4	3.5	70.6
1975	63.7	0.5	1.5	32.2
1976	46.9	4.3	3.1	43.0
1977	69.3	5.9	3.3	43.0
1978	64.4	16.1	13.2	6.3
1979	69.2	16.1	9.2	5.5
1980	64.2	24.3	8.1	3.4
1981	50.3	32.1	14.7	3.0
1982	37.2	30.7	16.3	15.8
1983	44.4	38.3	17.0	0.4
1984	52.1	37.7	10.1	0.2

Source: Brock (1986)

TABLE 9: SELECTED INDICATORS IN THE CHILEAN ECONOMY 1978-82 Rate of Growth of Nominal and Real Exchange Rate, of Ratio WPI/CPI; Manufacturing Index; Gap between Growth of GDP and Real Wage; Period 1978-1982.					
Year	Rate of growth of nominal exchange rate	Rate of growth of real exchange rate	WPI/CPI ratio rate of growth	Manufacturing index rate of growth	Gap rate of growth GDP-wage index
	(1)	(2)	(3)	(4)	(5)
1978	47.0%	5.6%	-2.9%	5.3%	-5.8%
1979	17.6	-4.2	10.7	6.6	-2.5
1980	47.0	-12.0	3.6	13.3	-0.9
1981	0.0	-7.8	-8.0	-18.4	-3.2
1982	30.5	26.0	-3.1	-13.1	-14.1

Source: This table was processed based on Balassa (1984).

TABLE 10: CAPITAL INFLOWS, AND LOANS IN FOREIGN CURRENCY TO TRADEABLE AND NON-TRADEABLE SECTORS IN CHILE: 1978 - 1982.

Year	Capital Inflow/GDP	Dollar loans to tradeable activities	(% of total loans) to non-tradeable intermediate activities construction loans
	(1)	(2)	(3)
1978	12.6%	64.4%	16.0%
1979	10.8	69.1	16.1
1980	11.5	64.2	24.2
1981	14.4	50.3	32.1
1982	5.4	37.2	30.7
Source: Column 1 was derived from data in selected Central Bank Bulletins Column 2 and 3 were taken from Brock (1986).			

TABLE 11: ANNUAL INTEREST RATE AND DEVALUATION INDICATORS IN CHILE: 1977 - 1982

Year	Average annual real rate of interest on Loans	LIBOR (real/peso) interest rate	Annual Rate of devaluation of peso (Dec-Dec)
	(1)	(2)	(3)
1977	37.8%	-5.6%	62.0%
1978	29.7	12.3	22.0
1979	8.4	11.7	0.0
1980	5.2	-14.5	0.0
1981	39.2	7.0	0.0
1982	47.0	38.3	85.0
Source: Central Bank Bulletins (various issues)			

TABLE 12: ANNUALIZED SPREAD BETWEEN DEPOSIT AND LENDING INTEREST RATES IN CHILE 1979 - 1983

QUARTER				
Year	(1)	(2)	(3)	(4)
1979	20.0%	16.4%	39.3%	14.0%

1980	9.8	10.9	9.2	7.8
1981	7.2	9.7	12.1	15.4
1982	16.2	15.3	26.3	15.0
1983	17.0	15.2	14.2	12.8

Source: Edwards & Edwards (1987)

TABLE 13: INVESTMENT AND SAVINGS IN CHILE: SELECTED YEARS: 1977 - 1982.

Year	Gross fixed capital formation/GDP	Gross domestic saving/GDP	Foreign saving/GDP
	(1)	(2)	(3)
1970	20.4%	21.6%	1.7%
1976	12.7	15.4	-1.9
1977	13.3	10.7	3.7
1978	14.5	11.6	4.8
1979	15.6	13.7	5.9
1980	17.6	15.5	8.5
1981	19.1	8.5	14.5
1982	14.0	n.a	9.2
1983	14.0	n.a	5.4

Source: Central Bank Bulletins (various issues)  
n.a = non available information.

TABLE 14: SELECTED INDICATORS ON THE CHILEAN FINANCIAL SYSTEM: 1973-1981

Year	Share of private sector credit total credit as of in June 30th	Credit to private sector in real terms (1975 = 100)	M2/GDP (a)
	(1)	(2)	(3)
1973	47.4%	77.2	10.7%
1974	82.5	88.2	5.4
1975	92.6	100.0	5.6
1976	88.0	136.8	5.9
1977	88.2	270.0	8.3
1978	95.0	444.3	10.4
1979	95.6	585.0	12.0

1980	98.0	817.2	13.2
1981	98.9	983.7	21.2

Source: Column 1 and 2 were taken from Central Bank Bulletins  
(various issues).

Column 3 is from Edwards & Edwards (1987).

(a) M2 = Private sector money plus time deposits of private sector

TABLE 15: CREDIT CONCENTRATION TO GROUP-RELATED COMPANIES IN CHILE AS A PERCENT OF TOTAL BANK PORTFOLIO FROM JUNE 1982 TO JUNE 1983

INSTITUTION	June 1982	Dec 1982	June 1983
Banco de Chile *	16.1	18.6	21.0
Banco de Santiago *	44.1	42.3	49.5
Credito e Inversiones	8.6	11.9	16.1
Sudamericano	13.0	14.8	17.9
Concepcion *	17.0	12.2	12.2
Colocadora Nacional *	23.4	23.8	25.4
International *	20.1	22.8	4.1 (a)
Total Chilean private banks	16.4	19.4	21.4
* Intervened Banks			
(a) The reduction of group-related credit here is explained by the legal dismemberment of this group, resulting in the separation of the bank from the other firms in the group.			

TABLE 16: CHILE: COMPOSITION OF IMPORTS.  
(As a Percent of Total Imports)

Year	Intermediate Goods	Capital Goods	Consumption Goods
	(1)	(2)	(3)
1971	61.8	17.1	21.0
1972	58.3	22.1	19.6
1973	66.0	19.8	14.1
1974	72.8	20.8	6.3
1975	65.2	28.3	6.5
1976	66.9	21.1	12.9
1977	57.3	20.9	23.3
1978	58.4	21.8	19.8
1979	59.0	20.8	20.2
1980	53.4	20.9	25.7
1981	50.4	19.6	29.9
1982	56.6	16.5	26.9
1983	69.2	12.1	18.8

Source: Central Bank Bulletins (various issues)